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TAGS: ECON EFIN EINV ETRD BR
SUBJECT: Brazil Responds to U.S. Financial Crisis

REF: SAO PAULO 486

¶1. (SBU) Summary: In response to the U.S. financial crisis, Brazil's Central Bank (CB) has partially reversed its hawkish anti-inflationary policies by adding 13.2 billion reais to the financial system in hopes of freeing up credit and has indicated that future interest rate hikes are unlikely given the diminishing threat of inflation due to a global slowdown and falling commodity prices. Brazil's Foreign Minster continues to assert that Brazil is well positioned to weather the crisis, while he and a key Central Bank contact also confirm moves to try to mitigate the effect of the crisis. President Lula continues to criticize the United States for a lack of financial regulation, claiming that a global regulatory body is needed to address the situation. Lula has admitted, for the first time, that the Brazilian economy may be adversely impacted by the crisis, drawing widespread criticism for not having a real grasp on the potential of the crisis. Brazilian market reactions are being reported by ConGen Sao Paulo SEPTEL. END SUMMARY

CENTRAL BANK ACTIONS AND INTROSPECTIONS

¶2. (SBU) The CB announced, on September 24th, a suspension in the implementation of new, higher reserve rate levels required for commercial banks. The new levels were to have been implemented in November, but the CB decided to delay this implementation by two more months. The CB also raised the threshold on commercial banks' exemptions for cash, time and savings deposits, which was previously at 100 million reais (approximately 200 million USD) to 300 million reais (approximately 600 million USD). The measure will return 13.2 billion reais(USD7.16 billion) to the financial system in what is a reversal to the original policy of removing 40 billion reais from the credit markets in an effort by the CB to slow lending growth that was fueling inflationary pressures. Responding to the U.S. financial crisis, the CB announced that this was a preventative measure meant to ensure sufficient availability of liquidity in the Brazilian financial markets. In their recently released quarterly inflation report, the CB diminished the role of inflationary pressures, claiming that the global economic slowdown and falling commodity prices will offset a devaluation of the Brazilian real and keep inflation in check. In fact, many economists have steadily lowered the year end inflation rate from 6.45 to 6.17 and many view the CB's most recent inflationary report as an indication that the CB will temporarily abandon their hawkish inflation stance and deviate from their recent rounds of rate hikes that saw an increase from 13 to 13.75 at their most recent meeting on September 9th.
¶3. (SBU) Central Bank of Brazil Senior Advisor Alexandre Pundek told Econ FSN, the main possible fallout from the Congressional rejection of the bailout package would be a reduction of credit lines to finance Brazilian foreign trade. Pundek also worries that if the crisis leads risk-averse Americans to shy away from investing

abroad, countries such as Brazil could experience a reduction in foreign direct investment. On the Brazilian monetary/credit policy side, Pundek reports that in addition to the measures reported above, the Central Bank has decided to postpone plans to subject lease lending (long term purchase installment plans)to phased-in application of new reserve requirements. The Central Bank will now apply the new requirements at a rate of 15 percent in March 2009 and 25 percent in June 2009. On the exchange rate policy side, Pundek says that the Central Bank recently sold two lots of 80 day forward purchase agreements at USD 500 million each in order to contain volatility. Finally, Pundek noted that inflation will likely fall depending both on international commodity prices, as well as the continued relative strength of the Real. Pundek observed that there is still a great deal of uncertainty and as a result, economic policymakers will refrain from forecasting.

¶4. (SBU) Alvaro Vereda, Deputy Secretary of International Affairs of the Finance Ministry confirmed for Econ FSN public statements by Finance Minister Mantega that the Ministry believes that the USD 700 billion White House package will be approved on a second round in the House of Representatives, and that as soon as it is approved, the credit situation will stabilize. After meeting with President Lula, Development Minister Jorge, Agriculture Minister Stephanes and Central Banker Meirelles, Finance Minister Mantega assessed that the Brazilian economy is functioning normally, although the CB (see previous paragraph) has recently conducted USD auctions to increase dollar liquidity. He also said that the Brazilian agricultural sector has sufficient resources, and that the GOB can tackle any problems ahead. Mantega asserted that Brazil has been suffering from the crisis, through the reduction of credit by private banks, but reinforced that the GOB is ready to act whenever necessary. According to the Minister, "the market is fine, the companies are solid, the banks are solid and the government is ready to respond to any problems put to them." Mantega noted that there should be a

distinction between advanced economies, the core of the crisis with financial institutions in trouble, and emerging and developing countries, whose economies are solid, domestic markets are robust, financial accounts are balanced and are growing more. The Minister mentioned that the Brazilian fiscal surplus in line with and above previous years' and that inflation is under control, within the ceiling limit of the target band (note: the limit is 6.5), which in turn enables the country to deal with the global situation on stable footing.

WHAT THE PRESIDENT SAYS

¶5. (SBU) President Lula meanwhile continued his public criticism of the U.S. financial crisis, commenting in interviews with Folha de Sao Paulo and Estado de Sao Paulo today (September 30)that the situation is the result of "casino-type" deregulatory practices and that the ultimate victims will be the poor. President Lula, at the UN General Assembly, called for a global solution to the financial crisis while proposing that the global financial crisis can only be resolved through multi lateral forums. Lula added that the crisis has proven market fundamentalists wrong and demonstrated the need for state interventions. Lula asserted at the U.N. that only decisive action by governments, especially those at the heart of the crisis, can correct the disorder that has spread throughout the global financial markets. In commenting yesterday on the proposal's failure to gain house passage, Lula implored the U.S. Congress to stop politicizing the bailout package and put national interest first. Lula has recently adjusted his position on what impact the crisis will have on the Brazilian economy, declaring initially that Brazil would be immune to the problems while admitting today that the crisis could do harm due to the enormity of the U.S. economy and the inevitable ripple effects. In today's editorial in Folha de Sao Paulo, Lula was criticized for not correctly predicting the crisis' impact on the economy; deriding him for his change in position and accusing him of not have the capacity to understand the gravity of the crisis. The editorial also depicted the CB president Henrique Meirelles as a curious, confused and powerless spectator.

¶6. Comment: Brazilians are very cognoscente of the country's past economic turmoil caused by global downturns (most recently the Asian crisis in 1997) and are quick to point out the advances in economic growth that the country has achieved, potentially partially

insulating Brazil from the current crisis. Despite the efforts of both President Lula and well respected commentators in easing the anxiety surrounding the U.S. crisis' potential impact, no one seems to know exactly how this will affect Brazil. The CB's attempt to maintain capital flows by partially reversing their monetary policy indicates that there is some recognition of the potential of the crisis' impact despite the rosy scenarios given officially (reftel). Whether that will be enough to mitigate a crisis of yet undetermined magnitude remains to be seen. The issue will likely be a topic of great interest during the planned visit of Under Secretary for Economic, Energy and Agricultural Affairs, Reuben Jeffery, to Brasilia on October 3rd when several interlocutors will likely look to the Undersecretary for insights into the unfolding developments surrounding the crisis. End Comment.

KUBISKE